FILE COPY

IN THE

Supreme Court of the United States

October Term, 1948

No. 520

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

L. B. HARTZ.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

DONALD B. SMITH,
Counsel for Respondent.

OF COUNSEL:
RANDALL, SMITH, BLOMQUIST &
KRAWETZ,
E-1422 First National Bank Building,
St. Paul 1, Minnesota.

INDEX

CITATIONS

Cases:

IN THE

Supreme Court of the United States

October Term, 1948

No. 520

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

L. B. HARTZ.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court, only considered and rendered by the one judge who heard the case

(R. 230-251), is not reported. The unanimous opinion (three judges sitting) of the Court of Appeals (R. 272-279) is reported in 170 F. 2d 313.

JURISDICTION

The judgment of the Court of Appeals was entered October 27, 1948 (R. 280). The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Did the court below correctly decide that the Tax Court erred in not holding that the parties really and truly intended to create a bona fide partnership as agree upon, because it failed to give due deference to the uncontroverted evidence that the partnership was created in good faith for the purpose of obtaining necessary working capital to insure the continued existence of the business and because it failed to recognize all of the contributions of capital, credit, services, management, and direction each partner made to the partnership?

STATUTES AND REGULATIONS INVOLVED

These are set forth in the Appendix, infra, pp. 13-15.

STATEMENT

The summarization of the facts by the petitioner is grossly misleading and in many instances incorrect. The following statement is therefore supplementary to the statement of the petitioner and corrective of errors contained therein:

The petitioner ignores the fact that the father, mother, sister, and taxpayer were all members of an admittedly bona fide and valid family partnership during the years from 1911 to 1917. This partnership conducted a truck farming business, which involved merchandising as well as growing, and gave those members of the partnership a background fitting them for the larger wholesale and retail food distribution business (R. 230, 272). It was really the origin of the business in question.

Petitioner states that prior to the taxable year taxpayer carried on the business in question as a sole proprietor. This is incorrect. From 1928 to the middle of 1937 the business was incorporated and conducted by the corporation. The incorporators were the taxpayer, his father, and sister. All of the members of the original family partnership were shareholders in the said corporation (R. 231, 232, 273, 274). The corporation was created for the purpose of obtaining "outside" capital, failed in its purpose, and was abandoned by its shareholders (R. 232, 273).

Petitioner states that the taxpayer borrowed various amounts from his sister, father, and mother during the early years in which the business was "expanding". This is incorrect. All of the initial working capital of the business came from the father and sister (R. 231, 273). Each cash investment of each partner was made at a critical time in the life of the business when there was either a serious

financial emergency or the business was decreasing, not "expanding". For example, in 1938 the father invested $1,000.00 at a time when the business was involved in a serious lawsuit and the funds of the business in several of the banks were garnished (R. 49, 50, 113, 114, 273, 237, 238). The wife contributed $400.00 at a time when checks were "bouncing" (R. 100, 157). The undisputed testimony of the taxpayer, his father, and sister was that they and the mother were to have an interest in the business by reason of their investments, and 6% interest (R. 273).

Total cash contributions to the capital of the business originating from sources outside the business as of the time of the hearing were as follows:

Taxpayer	$ 2,500.00	
Miss Louise K. Hartz	15,500.00	
Bernard J. Hartz	2,600.00	
Mrs. Louise K. Hartz	1,000.00	
Harriet L. Hartz	400.00	(R. 273, 274)

In addition to provisions of the partnership agreement referred to by petitioner, the agreement provided that each partner was to have free access to all books and accounts of the partnership, and each partner agreed to enter in the books all receipts, withdrawals, and other financial transactions involving any money or other property of the partnership, together with explanatory particulars with reference thereto. Authority to sign checks, notes, or other negotiable papers vested in taxpayer or any two of the other partners (R. 234, 235). Sharing of losses was in the same percentages as sharing of profits. The substantial independent means of the other partners were subjected to this liability (R. 239). The taxpayer had no means outside of his interest in the business.

The forms used to get the legal title into the names of the respective partners were employed to eliminate any question with the government of possible gift taxes. Gift taxes were paid to eliminate argument, although the parties did not consider the assignments as gifts (R. 67, 276), but a fulfillment of the understanding the parties had when investments were made (R. 67, 147).

In 1941 the taxpayer withdrew from the business a total of $2,995.06. From 1941 to and including 1945 all of the partners made comparatively small withdrawals from the business (R. 242).

Petitioner states that shortly after the formation of the partnership, the business was sued as a partnership in the United States District Court in Minnesota by two administrative agencies of the United States. This is incorrect. The business was not sued. The partners were sued. In one of these cases, a final judgment was entered, which is still in effect, restraining each of the partners—not the business. A partnership was found to exist in both cases (Exhibits 15 and 16).

The existence of the partnership was well known and widespread (R. 242, 276).

All of the partners participated in the direction and management of the business by giving advice and making suggestions as to the operations of the business at frequent and regular conferences (R. 69, 70, 189, 208, 215, 277). These meetings were not just report meetings as asserted by petitioner.

Petitioner's statement to the contrary notwithstanding, taxpayer's wife rendered vital services to the business "which were concededly greater than those ordinarily rendered by a wife in her husband's business" (R. 192, 279), and were ex-

actly the same type of work the taxpayer rendered in the same store at the same time (R. 143, 274). Among many other duties, the wife conducted the sample-testing for the business. The company guaranteed all of its products, and this testing was important and vital (R. 143, 144).

Petitioner admits that the business borrowed substantial amounts of working capital from a bank during 1941 and 1942. Petitioner neglects to mention that without this loan the entire business would have collapsed, and that without the formation of the partnership, the loan would never have been made (R. 251, 276, 277).

During 1940, and prior thereto, the business borrowed working capital from six different banks in the area. During 1940 these banks called their loans (R. 54, 55, 56). After the formation of the partnership, the business obtained bank credit up to $155,000.00 (R. 202, 205). The bank loaned this money by reason of the formation of the partnership because: (1) it did not like a "one-man business" and recognized the necessity of having "partners who can carry on the business," (R. 199) and (2) the partners, other than the taxpayer, had substantial independent means which were exposed to the liabilities of the business. The bank insisted the partners personally guarantee the loan to facilitate collection if necessary (R. 203, 239).

The Tax Court did not find that the partnership was created in bad faith or for the purpose of avoiding taxes. On the contrary, it found that the partnership was created for a real business reason, i. e., to raise immediately needed capital (R. 251).

The Court of Appeals did not hold that the Tax Court was obliged to accord tax effect to the gifts and the terms of the contemporaneous partnership agreement. The Court

of Appeals pointed out that the Tax Court had failed "to find and give due deference to the uncontroverted evidence that this partnership was created in good faith for the purpose of obtaining necessary working capital to insure the continued existence of the business," and that there was ample justification for the assignments which were made by the taxpayer to the partners. The assignments were not gifts. The Court concluded that "This record compels the conclusion that this was a valid partnership" (R. 279). But the Court of Appeals said, "In so holding, we do not mean to say that a division of income between alleged partners must necessarily be adhered to for tax purposes merely because it is written into an alleged partnership agreement."

REASONS FOR DENYING THE WRIT

1. The Decision of the Court of Appeals is Correct and not Contrary to any Decision of this Court.

This is not the case of *Commissioner vs. Culbertson*, No. 313, or anything like it. In that case, petitioner asserted "that taxpayer's four sons contributed no capital of their own, nor any vital additional services (managerial or otherwise) to the business, and hence did not become his partners for tax purposes." (See Petition for Writ, No. 313, p. 10.) In this Hartz case, each partner did contribute capital to the business which originated from sources outside of the business. In fact, the sister and father contributed a greater amount of such capital than did the taxpayer. But for such contributions, the business would never have come into existence, nor would it have survived. Each of the partners actually took part in the direction and management of the busi-

ness. There were regular family conferences held, at which times all of the partners reviewed the past and took part in making plans for the future. It cannot be doubted that much of the success of this business depended upon the perspective given it by the partners. The taxpayer's wife rendered vital additional services to the business—services which were the same as those rendered by the taxpayer, and which were concededly greater than those ordinarily rendered by a wife in her husband's business.

Apparently the petitioner has completely misunderstood the decision of the Court of Appeals. The court below did not hold that members of a taxpayer's family were entitled to recognition as business partners merely by virtue of a contribution of some capital to the business, and that the taxing authority was thereby foreclosed from inquiry into the relationship between the contribution and the allocation of the business income agreed upon by the partners. Nor did the court below hold that the wife became a partner for tax purposes by virtue of a gift to her. The Court of Appeals held quite to the contrary and followed *Commissioner vs. Tower*, 327 U. S. 280, and *Lusthaus vs. Commissioner*, 237 U. S. 293.

The court expressly stated that the taxing authority is not bound by any artificial or unwarranted division of income which might be agreed upon by the partners. It was recognized and stated that a taxpayer could not avoid taxes by creating an artificial partnership, nor could he deflect a portion of his earned income from one partner to another upon any unreasonable basis.

The Court of Appeals accorded the high respect to which the Tax Court's findings were entitled.[1] It did not hold that

[1]Section 36 of Public Law 773, approved June 25, 1948, and effective September 1, 1948, amending Section 1141(a) I. R. C.

the facts found by such court were not supported by the evidence. The Tax Court had overlooked some undisputed facts and had reached obviously incorrect conclusions of law from the facts it had found.

The Tax Court erred when it neglected to give each of the partners due credit for the following uncontroverted facts:

1. That they risked their capital in a new and risky business, at times when strangers were unwilling to invest capital in the business.[2]

2. That they risked all of their substantial independent means in order to enable the business to obtain credit at a time when outsiders, bankers, who knew the business, were calling all their loans.

3. That they became "partners who (could) carry on the business" when and if necessary in order to enable the business to get substantial and necessary bank credit.

4. That in the business world, a large Minneapolis bank thought the partnership was real enough to extend credit up to $155,000.00.

5. That they did render services to the business, which services were of value to the business.

6. That they did contribute valuable ideas and suggestions for the operation of the business, and participated in its management and control.

7. That they contributed a valuable perspective to the business, which the taxpayer, so close to the business, could not have had.

---

[2]The value of money to a business is relative, depending on its need and its availability. In the beginning, money could not be had at any price. Only the relatives who had faith were willing to put money into the business. Even after the business was established and incorporated, it was impossible to sell stock and raise necessary outside capital. The value of early risk capital is well known. *Jay A. Mount*, 5 T. C. M. 1004, P-H Memo T.C. ¶ 46, 276; *Thomas F. Kelley*, 9 B. T. A. 834; *H. D. Webster*, 4 T. C. 1169; Estate of *Frank G. Ennis, Sr.*, 5 T. C. 1096; *Leo Marks*, 6 T. C. 659; *Weizer vs. Commissioner*, 165 F. 2nd 772; *Wilson vs. Commissioner*, 161 F. 2nd 661.

8. That at the time of the formation of the partnership, the partners agreed to and thereafter did contribute substantial additional capital which originated from outside sources.

2. The Issue of Reallocation is not Before this Court and was not Before the Lower Courts.

While the Court of Appeals obviously found that the division of profits between the partners was fair and reasonable, which finding accords with the evidence, the question of reallocation was never before either the Tax Court or the Court of Appeals.

The Commissioner assessed all of the income of the business to the taxpayer. In the taxpayer's petition to the Tax Court, he alleged there was a valid and bona fide partnership as set out in the partnership agreement (R. 3, 4, 5). The Commissioner, in his answer, maintained his initial position and denied there was any partnership (R. 9, 10, 11). In fact, he denied there was any contribution of anything to the partnership by any of the partners other than taxpayer. At no time during the trial or in his brief following the trial did the Commissioner suggest that the income of the business should be reallocated between the members of the partnership.

The question of whether the parties really and truly intended to create a partnership or, as to that issue, whether the allocation of income of the business as agreed upon by the parties was reasonable, is quite different from whether the income should be reallocated, and if so, on what basis. Had reallocation been a proper issue in the case, evidence of the contribution of each partner to the partnership would have

been much more detailed and elaborate. Specific evidence of the relative value of each respective contribution by each partner would have been submitted if possible.

It is elementary that no court will consider issues not raised by the pleadings.[3]

The "Bureau Policy",[4] to enable agents to settle family partnership cases on a basis other than that agreed upon by the partners, was issued subsequent to the trial of this case before the Tax Court.

3. No Important Issue is Presented by This Record.

Of all the many family partnership cases before the Tax Court (about 350), only five other cases have involved any consideration of reallocation.[5]

The facts and conclusions in this case are peculiar to this case and cannot be determinative of any other case.

[3]*Reynolds v. Stockton*, 140 U. S. 254; *S. E. Boozer*, 6 T. C. M. 1021 *William F. Horsting*, 5 T. C. M. 421; *Wentworth Mfg. Co.*, 6 T. C. 1201; *Eric H. Heckett*, 8 T. C. 841; *Maurice P. O'Meara*, 8 T. C. 622. Rule 14 of the Rules of Practice of the Tax Court provides,—"Answer . . . The answer shall be so drawn as fully and completely to advise the petitioner and the Court of the nature of the defense." P-H. ¶21, 577.

[4]See "Bureau Policy with Respect to So-called Family Partnerships", IT 3845, 1947-1 Comm. Bull. 66.

[5]The first case of *Max German*, 2 T. C. 474, was not really a reallocation case because the court found there was no partnership between the husband and wife in the personal service business, no partnership agreement having been made during the taxable year, but did allocate 25% of the income to the wife and 75% to the husband. In the case of *William J. Hirsch*, 4 T. C. M. 4, the Commissioner sought reallocation but the Tax Court rejected the idea because of its "impracticability". In the cases of *Canfield v. Commissioner*, 168 F. 2d. 907, and *Woosley v. Commissioner*, 168 F. 2d 330, the Court of Appeals held the facts in neither case warranted reallocation. No review was sought in either of these two cases. The case of *David L. Jennings*, 10 T. C. 505, involved a personal service business, and the taxpayer agreed to a reallocation in the Tax Court. There are now no reported reallocation cases pending. See P-H ¶ 15, 508. The case of *Walsh v. Commissioner*, 170 F. 2d 525, cited by petitioner, does not involve any question of reallocation. No review will be sought in this case. P-H 71,040.

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted,

DONALD B. SMITH,
Counsel for Respondent.

OF COUNSEL:
RANDALL, SMITH, BLOMQUIST &
KRAWETZ,
E-1422 First National Bank Building,
St. Paul 1, Minnesota.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.

(26 U.S.C. 11.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him —

* * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U.S.C. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof —

* * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust, or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * * *

(26 U.S.C. 3797.)

SEC. 1141. COURTS OF REVIEW.

(a) Jurisdiction.—The circuit courts of appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in Civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner pro-

vided in section 1254 of title 28 of the United States Code.

* * * * *

(c) Powers.—

(1) To affirm, modify, or reverse.—Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require.

(26 U.S.C. Sec. 1141(a)(c))

28 U.S.C. SEC. 875.

"875. *Review in cases tried without jury.*—When an issue of fact in any civil cause in a district court is tried and determined by the court without the intervention of a jury, according to section 773 of this title, the rulings of the court in the progress of the trial of the cause, if excepted to at the time, and duly presented by a bill of exceptions, may be reviewed upon appeal; and when the finding is special the review may extend to the determination of the sufficiency of the facts found to support the judgment."